The Real Estate
ANALYST

APRIL 29
1955

Volume XXIV

Number 16

As I See

THE PRINCIPLE OF THE SHARED RISK

THE free enterprise system is quite frequently referred to as a profit and loss system. During the past 20 years, however, a large percentage of the people of the United States have tried to change the nature of our economy to one in which the entrepreneur would take the profits but, should a loss develop, the Government (the taxpayer) would assume the loss. This assumption of loss by the Government started during the depression with what might be called disaster insurance. Because of the devastating impact of the depression, the Federal Government attempted to put a floor under losses. Since the farmer had been in a declining market since 1920, he was the first to benefit from subsidized profits. The idea was advanced and accepted that the farmer for some mysterious reason was entitled to "parity" with other elements in our population, and it was assumed that certain ratios which had existed in the past between the cost of the things which the farmer buys and the selling price of his products were right and should be maintained on the same relationship indefinitely into the future. While such a conception might work in a static economy, it is certainly unwise to assume that there was anything sacred about price-cost relationships at some period in the past which should automatically carry over into the future.

In the United States we operate in a price economy. Market price determines what and how much will be produced. If demand increases faster than supply, prices increase until a sufficient number of additional producers are brought into the market to take care of the increased demand. When supply exceeds demand, prices decrease until a sufficient number of the higher-cost producers are forced from the market, reducing the supply until demand at the lower price can absorb what the market will produce at that price. Whenever price is held above the amount which would be arrived at in a competitive market, the incentive to produce is strong and production will exceed demand. When production exceeds demand, surpluses are built up, and as surpluses accumulate, it becomes more difficult still to hold the artificial price. Many persons have come to believe, however, that various segments of our population should be supported by Government subsidies if demand at the controlled price is not high enough to clear the market.

Subsidized production, which started with the farmer, has now spread through many parts of the economy until it has reached the field of real estate. During the middle and later forties the Federal Government, through the FHA, insured mortgages on large apartment projects. The builder of the project assumed no risk, as he was allowed to recapture not only his cost, but in some cases a very exorbitant profit out of the proceeds of the loan. The mortgage lender assumed no risk, as the entire amount of the loan was insured by the FHA. In case the project proved to be uneconomic, the builder still had his normal profit plus in many cases a windfall distribution from the excess loan, and the mortgage lender was guaranteed by the Federal Government that he would receive back, dollar for dollar, not only the amount which a prudent lender would have loaned on the project, but also the amount which was loaned which was in excess, sometimes by a large percentage, of the actual cost of the project.

In the single-family residence field, on a smaller scale insofar as the individual property is concerned, but on a much larger scale in aggregate dollars, the Federal Government is again offering to hold the bag, reminding one of the paraphrased slogan: "When bigger bags are built, the United States will hold them."

I am not opposed to disaster insurance. I believe that there sometimes comes a time when an individual, trying as conscientiously as he can, needs protection from his Government against unforeseen and unpredictable calamities. On the other hand, I feel very positively that the Federal Government has no justification whatsoever in trying to ensure a certain standard of living for any particular group of its citizens.

I have long believed that the only security for a free people rests in insecurity. Dr. Marcus Nadler, consulting economist to the Hanover Bank, said the other day: "The willingness to take risks goes hand in hand with economic progress." He continued: "Where people refuse to take risks and prefer to invest only in high-grade, fixed income bearing securities, the economy of the country is bound to stagnate." The security I want for myself can be best obtained by intelligence, industry and thrift.

At some times, however, economic forces might be such that the individual must depend on disaster insurance, and in such a case there is a field in which the Government should assume a portion of the risk. Even in these cases, however, I believe in the shared risk. By this I mean that if a mortgage lender lends more on a mortgage than a prudent lender should lend and a loss develops, at least a portion of this loss should be borne by the lender whose judgment was at fault. Only in this way will lenders remain prudent and will losses be held to a minimum. I believe that a builder who builds a building, the cost of which is excessive from the standpoint of the current demand, should lose a portion of his

capital and should not expect the Federal Government to pay the losses entailed by his lack of judgment. I believe that a promoter promoting a real estate venture should make a profit if the venture proves sound, but if the venture should be poorly conceived and poorly timed, the promoter should share in the loss. I believe that if an individual, be he a veteran or not, should decide to purchase a house, should his judgment prove false either as to location, design or type of construction, he, too, should share in the loss.

Unless the individual citizen shares in the risk, the Federal Government will constantly have foisted upon it by various pressure groups all sorts of unwise and ill-advised methods of disposing of the taxpayers' money.

That we have not followed this principle is self-evident to anyone watching the classified advertisements of our metropolitan dailies. Not only in many cases have we ceased to demand a down payment, but in a number of cases various types of equipment are added to the deal and the mortgage in order to give the prospective purchaser a bonus for buying on credit.

We have already seen the ill effects of the unshared risk in agriculture and in the 608 loans made by the FHA. In agriculture, billions of dollars worth of agricultural products have been accumulated because the price of these products was held so high that the buying public was not willing to clear the shelves at that price. We have traded and given away billions of dollars worth of commodities, and these commodities still accumulate faster than storage space can be built to house them. The windfall profits on 608 projects of the FHA are too well known to require much comment, but I believe it is significant that in 1947 I spoke to the Savings Banks Association convention at Lake Placid, New York, and said in my talk that I believed the 608 loans being made were not sound. After I finished my talk, the president of one of the largest savings banks in the United States told me that he agreed, but he said that the pressure of funds coming into his bank was so great that they were making 608 loans in considerable quantities with the conviction that they were probably buying a great many Government debentures. The vice president in charge of real estate and mortgages of this same savings bank testified before an investigating committee of Congress thatthey loaned an amount on an FHA project which later proved to be 150% of its total cost, and when asked whether they hadn't made an independent investigation as to the soundness of the project, he replied that they had not, but that they were depending on the Government guaranty. There have been cases, of course, in the past, where bankers, lacking either ordinary prudence or honesty, have loaned their depositors' money on unsound loans, but until the Government offered to assume the risk, these cases were the exception.

I fear for the future of the real estate market because of the unwise prac-

tices which have been followed during the past 10 years and which are being followed today. The real estate operator accepting a Government underwriting of his total risk will sooner or later find that with this Government subsidy comes Government control. The farmer has discovered that in return for pegged prices and Government purchases of his surplus came Government controls on acreage, types of planting and price. In self-protection, the Government cannot continue to insure and guarantee loans which a prudent investor would not feel justified in making unless it limits its losses by controlling the projects that go forward and the prices at which these projects will be sold. The most certain way to destroy a free market, and with it a free economy, is to try to play a "heads I win - tails you lose" game with the Government.

ROY WENZLICK